

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE,

Petitioner

V.

LILLIAN E. YAEGER,

Respondent

EMMA M. HEBER AND ESTATE OF HENRY D. HEBER, DECEASED,
EMMA M. HEBER, ADMINISTRATRIX,

Petitioners

V. 2

COMMISSIONER OF INTERNAL REVENUE,

Respondent

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT
OF THE UNITED STATES

BRIEF FOR RESPONDENT YAEGER

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Steeve v. Yaeger, 145 Cal. App. 2d 704 (1956)

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Internal Revenue Code of 1954:
 Sec. 61 (26 U.S.C.1958 Ed., Section 61)
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 Civil Code of the State of California, Division 2,
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IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

No. 20085

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

LILLIAN E. YAEGER,

Respondent.

No. 20086

EMMA M. HEBER AND ESTATE OF HENRY D. HEBER, DECEASED,
EMMA M. HEBER, ADMINISTRATRIX

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT
OF THE UNITED STATES

BRIEF FOR THE RESPONDENT YAEGER

STATEMENT DISCLOSING BASIS OF JURISDICTION

OF THE TAX COURT AND OF THE COURT OF

APPEALS OF THE NINTH CIRCUIT

Respondent is an individual taxpayer residing in the
City of Fullerton, California.

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The respondent, Lillian E. Yaeger, an unmarried woman, filed timely cash basis personal income tax returns for the calendar years, 1956, 1957 and 1958 (the years here involved) with the District Director of Internal Revenue in Los Angeles, California, and paid to the said District Director the tax therefor by the said returns. The District Director of Internal Revenue at Los Angeles, California, and the collection department administered by him is within the jurisdiction of the United States Court of Appeals for the Ninth Circuit. Taxpayer's petition to the Tax Court of the United States (Tr. Vol. I, PP1-14) set out all of the pertinent jurisdictional allegations.

Pursuant to the taxpayers petition to the Tax Court of the United States and the resulting decision rendered by the Tax Court in Lillian E. Yaeger v. Commissioner of Internal Revenue, T.C. Docket No. 4496-62, Commissioner of Internal Revenue filed a petition for review. (Tr. Vol. I, PP97-100).

The above case was consolidated for trial purposes with the Tax Court of the United States with a companion case, Heber, et al v. Commissioner of Internal Revenue, T.C. Docket No. 4543-62. Mrs. Heber had also filed a petition with the Tax Court of the United States involving deficiencies arising out of the same facts as the respondent's petition. The Commissioner of Internal Revenue had taken diametrically opposed position in the two cases, and they were consolidated for trial in the Tax Court. As a result of the decision

therein, Mrs. Heber also filed a Petition for Review (Tr. Vol. I, PP104-212) and again the two cases have been consolidated for appeal before the United States Court of Appeals for the Ninth Circuit (Tr. Vol. I, PP135-137). Jurisdiction in both appeals is conferred upon this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTIONS PRESENTED

The instant cases arose out of the same basic fact situation in which Mrs. Heber and Miss Yaeger, who had been partners in the ownership of certain real property, terminated this relationship in 1944 by executing an agreement dividing the properties whereby Mrs. Heber received a vested interest of a life estate in an undivided one-half of the properties as subsequently interpreted and adjudicated by California State Court and the questions are now presented as follows:

1. Can Miss Yaeger be taxed on the income from one-half of the properties which the State Court of California has determined to be the property interest of Mrs. Heber?

2. Should the Tax Court's decision be now modified to permit deductions for Miss Yaeger in the years 1955 and 1957 which were directly consistent and allowable on the basis of the Tax Court's finding that Mrs. Heber did own an undivided one-half interest in the properties?

STATUTES INVOLVED

Internal Revenue Code of 1954:

SEC. 61. GROSS INCOME DEFINED.

(a) General Definition.--Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

* * *

* * *

(5) Rents;

* * *

* * *

(26 U.S.C. 1958 ed., Sec. 61.)

STATEMENT OF FACTS

Mrs. Heber and Miss Yaeger had been friends and companions for many years. They resided together beginning with the year 1935 and continued to reside together until shortly before Mrs. Heber's marriage in 1947 to her now deceased husband. Mrs. Heber has been a registered nurse since 1927 and Miss Yaeger has dealt in real property both as a manager and a broker for fifty years.

In 1939 the parties entered into an equal partnership whereby they acknowledged that they were to be equal owners of certain properties described therein as Parcels 1 and 2. The agreement provided that the partnership was intended to acquire additional properties and

that the partners were to manage and develop these properties for the equal benefit of both. Further provided that if either party wished to withdraw from the partnership, said partner must first offer to sell or purchase the one-half partnership interest owned by the other party and that in the event that no agreement of sale or purchase could be arrived at by the parties, the partnership was to be dissolved and the proceeds thereof divided equally between the partners. (Tr. Vol. I, PP52-53).

Parcels 1 and 2 were occupied by building improvements thereon and were regularly rented to produce partnership rental income. During the subsequent course of the partnership activities the partnership acquired a liquor store and certain unimproved lots which were non-income producing and designated as Parcels 3, 4, 5 and 6. During early 1944 the partnership also acquired some property designated as Parcel 7 which contained a number of citrus trees but was not productive of income. (Tr. Vol. I, PP53-54.)

August 10, 1944, Mrs. Heber and Miss Yaeger executed a termination agreement, the meaning and interpretation of which have caused controversy in these tax cases here consolidated for review. The agreement recited there had been a partnership and set forth a description of the Parcels 1 through 7 then owned as partnership property. It recited that for various reasons legal title was not in the partnership name but was in each case being held for the benefit of

the partnership. The agreement then went on to recite that the parties desired to change their relationships and to partition and divide the properties whereby the legal title in each piece of property would be vested in Lillian E. Yaeger but "reserving a life estate in and to one-half of the rents, issues and profits to the party of the second part for and during the period of her natural life" (Part of the second part being Mrs. Heber).

The agreement went on to provide in Paragraph 4 that except as to the liquor store which was to be disposed of the co-partnership agreement previously entered into by the parties would not apply to the future activities regarding Parcels 1 through 7. Paragraph 5 provided that all the Parcels would be disposed of except Parcels 1 and 2 and the proceeds therefrom would be applied to reduce the indebtedness on Parcels 1 and 2 thereby maximize the rental income from Parcels 1 and 2.

The agreement further provided that in the event that one-half of the net income of the properties was insufficient to care for the parties respectively by reason of illness, want or other necessity or to obtain necessary medical or other assistance for or during the periods of illness, want or other necessity, then the parties agreed to use so much of the principal or corpus of the properties described as would be necessary to care for the party in need.

Besides providing for a monthly drawing account against

the annual net rentals of one-half due to each party the agreement also provided in Paragraph 10 that no future indebtedness could be created or incurred on the properties without the express consent of both parties. Paragraphs 11 and 12 provided for accurate books of account and that proper accounting statements would be rendered for the benefit of both parties on an annual basis. (Tr. Vol. I, PP54-56 and PP118-125.)

Deeds were recorded in accordance with the termination agreement. Thereafter at all times relevant hereto Miss Yaeger continued to manage and control the Fullerton properties spending her time and efforts in keeping the properties rented, paying the expenses and supervising the maintenance and upkeep of the properties in general for the benefit of both parties. (Tr. Vol. I, PP57)

Miss Yaeger's purpose in causing Mrs. Heber to execute the termination agreement was to reshuffle their interests in the partnership properties in order to reflect the fact that Mrs. Heber, because of illness, had become unable to assist Miss Yaeger in any of the affairs of the partnership. When Mrs. Heber and Miss Yaeger executed the termination agreement, it was the belief and intention of each of them that the partnership theretofore existing between them was thenceforth terminated. Each of them was aware at that time that Miss Yaeger was receiving thereby a life estate in an undivided one-half of the properties, measured by Mrs. Heber

life, plus the entire ownership of the properties upon Mrs. Heber's death. (Tr. Vol. I, PP51-58)

Thereafter Miss Yaeger managed the properties for the benefit of both parties and paid Mrs. Heber her monthly drawing against her one-half share of the net income of the Fullerton properties until 1948. Miss Yaeger then ceased paying monies to either herself or Mrs. Heber as a drawing against their respective shares of net income from the properties. Miss Yaeger did begin paying herself a manager's salary of \$200.00 per month for maintaining the rental properties. All other rental monies received were being utilized to either pay expenses of keeping up the properties or to reduce the indebtedness against them. (Tr. Vol. I, PP.58)

In January, 1949, Mrs. Heber became discontented with Miss Yaeger's management of the properties and sought legal counsel. Settlement negotiations were attempted but in August, 1949, Mrs. Heber initiated proceedings against Miss Yaeger in the Superior Court in and for the County of Orange, State of California, whereby she sought to rescind the termination agreement, reform it, obtain declaratory relief as to its meaning and terms and to quiet title in the property. The Court, in its unreported opinion primarily determined that Mrs. Heber had a vested life estate as an undivided one-half interest in the Fullerton properties for and during her life and that Miss Yaeger had

not remitted Mrs. Heber's one-half share of the net income derived from that property interest of Mrs. Heber. This decision was appealed on several grounds by Miss Yaeger, the results of which were reported by the District Court of Appeals, Fourth District, California, and entitled Steeve v. Yaeger, 145 Cal. App. 2d 455, 302 P. 2d 704 (1956). This decision clearly affirmed the lower courts findings of fact and application of law in the State of California and Mrs. Heber was clearly possessed of an undivided one-half life estate in the Fullerton properties. (Tr. Vol. I, PP58-60).

Miss Yaeger paid the amounts awarded to Mrs. Heber pursuant to this judgment, as follows (I-R. 60):

<u>Year</u> <u>Paid</u>	<u>Payments on</u> <u>Judgment</u>	<u>Interest</u>
1955	\$ 9,086.39	--
1957	18,007.06	\$5,509.30
Total	\$27,093.45	\$5,509.30

Because Miss Yaeger had previously reported some of this income now paid to Mrs. Heber in her own returns during the years, 1944 to 1952, Miss Yaeger deducted that portion of income so reported and paid to Mrs. Heber on Miss Yaeger's 1955 and 1957 returns. These deductions were accepted by the Commissioner but later disallowed as being inconsistent with the asserted deficiencies herein involved and based on the contention by the Commissioner that Miss Yaeger was in fact chargeable with income for tax purposes derived from the one-half interest owned by Mrs. Heber. (Tr. Vol. I, PP.10 and 13).

Thus the case has now evolved wherein the Tax Court

found that the deficiencies asserted against Mrs. Heber were correct in assessing a tax to her as a recipient of ordinary income derived from her undivided one-half life estate interest in the Fullerton properties. The Court has further found in effect that Miss Yaeger was not taxable on this same income but was taxable only as to her own undivided one-half interest in the Fullerton properties during the life of Mrs. Heber. However, the Tax Court opinion did assume that Miss Yaeger abandoned her deductions claimed in 1955 and 1957 and therefore a portion of the deficiencies asserted by the Commissioner against Miss Yaeger have been included in the Tax Court's decision.

SPECIFICATION OF ERROR RELIED ON BY RESPONDENT

The Respondent, Yaeger, appears here primarily to respond to the Commissioner's specification of error that in the event this Court determines that Mrs. Heber is not taxed on one-half of the income from the Fullerton Properties in spite of her life estate ownership interest therein, the tax should be taxed to Miss Yaeger. To this extent, of course, the Respondent here urges that no error was made by the Tax Court below.

However, for the facts and reasons set forth hereafter as Argument II, the Respondent does urge that an error was made by the Tax Court in assuming that Miss Yaeger had abandoned her issues regarding deductions in the year 1955 and 1957 when in fact these deductions were not separate

issues to be decided but should have automatically been sustained and included in the Court's determination and holding on the issue that Mrs. Heber was taxable on one-half of the income from the Fullerton Properties.

SUMMARY OF ARGUMENT

1. Mrs. Heber's share of the rental income from the Fullerton Properties which she received from Miss Yaeger under the terms of a California court judgment during 1955, 1956 and 1957 was taxable to her as ordinary income as determined from the facts submitted to this Court, including the interpretation of the Agreement between the parties dated August 10, 1944, the Tax Court properly found that Mrs. Heber did in fact own an undivided one-half life estate in the Fullerton Properties during the taxable years for which the payments were made to Mrs. Heber. Mrs. Heber has not demonstrated that these facts as determined by the Tax Court are clearly erroneous or should now be set aside by this court.

The Tax Court's opinion is consistent with the findings and opinion of a California court wherein the parties had previously litigated the nature and extent of the property herein controlling the tax consequences complained of by Heber. Mrs. Heber accepted the fruits and benefits of the state court's decision as to her property interest and income earned therefrom but now wishes to relitigate the matter as to tax consequences.

The Respondent submits that the state court's determination of the property interests is now binding on the parties and

also that the Tax Court could not have refused to recognize and accept the property interests found by the state court. The facts as found by the Tax Court would not warrant the argument that the state court decision between the parties was collusive or non-adversary and therefore need not be followed by the Tax Court. Also, the facts do not warrant Mrs. Heber's arguments that in reality she received something else different from a life estate interest in the property. The law of taxation respects the argument that substance controls over form but the economic realities of this case clearly reflect that Mrs. Heber did in fact enjoy all of the benefits and also suffer the burdens and risks of an owner's interest in the Fullerton Properties. Thus, regardless of the characterization of how Mrs. Heber acquired her interest by purchase, partnership distribution, or as consideration in exchange of her former interests, Mrs. Heber did own and possess the property interest. She in fact continued to receive the same benefits of income that she had previously enjoyed as a partner in the Fullerton Properties.

2. Regarding the Respondent's specification of error on her appeal, Miss Yaeger seeks to correct the error by the Tax Court in assuming that she had abandoned certain deductions. Since the property of the deductions had already been accepted by the Commissioner prior to this tax case and were herein disallowed only as a part of the basic issue regarding the taxability of Mrs. Heber's interest in the Fullerton Properties. As stated by the Tax Court, the deductions should have been allowed because Mrs. Heber owned a one-half life estate in the properties.

ARGUMENT

I

THE TAX COURT'S DETERMINATION THAT HEBER'S RECEIPT OF MONEYS FROM THE FULLERTON PROPERTIES WAS AS AN OWNER OF A LIFE ESTATE IN SAID PROPERTIES AND THEREFORE TAXABLE TO HEBER AS ORDINARY INCOME IN THE YEAR OF RECEIPT WAS CORRECT AND PROPERLY SUPPORTED IN FACT AND IN LAW.

On Appeal here, Mrs. Heber contends in her brief (H. Br., 8, 23 and 27) that the Tax Court's determination that the moneys received by Heber were ordinary income to her because they were paid to her as owner of a life estate interest in the Fullerton properties was incorrect. Mrs. Heber asserts that the Tax Court's findings and its opinion based thereon are not supported by the facts or law applicable thereto. The Respondent submits that the Tax Court's decision was correct and that Mrs. Heber's contention in this regard is not supported by the record now before this Court.

A. The Tax Court Held that From all the Facts Before the Court, Mrs. Heber was the Owner of a Life Estate in an Undivided One-half Interest in the Fullerton Properties

The Tax Court in its Opinion (Tr. Vol. I, PP. 69-70) stated that upon examination of all of the facts before it, it was clear that after the execution of the termination agreement (Ex. 9-I, Tr. Vol. I, PP. 118-125) by Mrs. Heber (i. e., Steeve) and the Respondent, Miss Yaeger, Mrs. Heber was left with a life estate in an undivided one-half of the former partnership properties. The Court further stated that as a result of the same document, Miss Yaeger was left as tenant in common with Mrs. Heber, with a life estate measured by Mrs. Heber's life in the same properties as to an

undivided one-half interest and a future interest in the entire remainder of the properties. These conclusions are clearly supported by the Court's Findings of Facts as follows:

(1) Tr. Vol. I, PP. 54, 55 and 56 - The Agreement of August 10, 1944, provided that the parties, Mrs. Heber and Miss Yaeger, agreed to divide all of the real property known as the Fullerton Properties whereby fee title would be vested in Miss Yaeger subject to a life estate in and to one-half of the rents, issues and profits to Mrs. Heber for the duration of the period of her (Mrs. Heber's) natural life. The properties included seven parcels of land.

(2) Tr. Vol. I, PP. 56 and 57 - Pursuant to the execution of the Agreement of August 10, 1944, deeds were executed and recorded to convey the exact interests defined above whereby Mrs. Heber received a life estate to one-half of the income of parcels one through seven.

(3) Tr. Vol. I, PP. 9 - The Court found that the parties were aware at the time the Agreement of August 10, 1944, was executed that Mrs. Heber was receiving a life estate in an undivided one-half of the properties, measured by Heber's life.

These findings were based on uncontroverted evidence either stipulated to or admitted during the course of the proceedings before the Tax Court. Regarding the Agreement of August 10, 1944, it is set forth in the record herewith at Tr. Vol. I, PP. 118 to 126. The deeds referred to were

stipulated to by all parties as set forth in Stipulation of Facts (Tr. Vol. I, PP. 44, 45 and 46 and specifically as Exhibits 10-J, 11-K, 12-L and 13-M). The intent and awareness of the parties regarding the factual determination that Mrs. Heber was to receive a life estate in one-half of the Fullerton Properties is set forth in the testimony of the parties themselves. Miss Yaeger clearly stated that this result was intended by her for Mrs. Heber's own benefit (Tr. Vol. II, PP. 50, line 16). Counsel for Mrs. Heber in no way sought to contradict or challenge this intent of Miss Yaeger by either cross-examination or other evidence. In Mrs. Heber's own testimony regarding both the circumstance surrounding the execution of the August 10, 1944 agreement (Tr. Vol. II, PP. 79) and reporting of the income from said properties (Tr. Vol. II, PP. 81 and 82), it is apparent that she accepted the life estate result herself without question. Suffice to say, Mrs. Heber's only objection even now to this factual result is that it imposes a tax burden upon her which none of the parties either discussed, considered or even anticipated at the time the crucial agreement was executed.

The Respondent submits that these Findings of Fact were clearly supported by the evidence and cannot now be set aside under Rule 52(a) of the Rules of Civil Procedure. Also, see Wellington v. Commissioner, 196 F.2d 421 (C.A. 7th, 1952) and Omaha National Bank v. Commissioner, 183 F.2d 899 (C.A. 8th, 1950). Mrs. Heber has in no way offered to

show that they were clearly erroneous as required under Rule 52(a), supra.

- B. The Tax Court's Conclusion from the Facts Regarding the Determination that Mrs. Heber Owned a Life Estate in One-half of the Fullerton Properties is Consistent with a Prior California Court's Determination of the Same Issue
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The Tax Court in both its Findings of Fact (Tr. Vol. PP. 10) and Opinion (Tr. Vol. I, PP. 20), cited the decision of the California court in Steeve v. Yaeger, 145 Cal. App. 704 (1956). Further, the parties themselves stipulated said decision into evidence (Tr. Vol. I, PP. 46). It was in this case that Mrs. Heber sought redress from Miss Yaeger for failing to pay over the income due Mrs. Heber as a life estate tenant in one-half of the income from the Fullerton Properties. Actually, Mrs. Heber there sought a complete rescission, reformation, declaratory relief and action for quiet title. The Court found that from all of the facts submitted regarding the Agreement of August 10, 1944, its execution and the parties' intent regarding it, that Mrs. Heber had an absolute and unfettered right to an undivided one-half interest in the Fullerton Properties for the period of her natural life, subsequent to the date of said agreement. The Court considered the circumstances carefully, including the alleged domination of Miss Yaeger over Mrs. Heber, the fact that the documents were drawn by an attorney who allegedly was Miss Yaeger's, and that the parties were in fact dissolving their partnership. From proof submitted

the Court found (page 462 of that reported opinion) that the parties without doubt each understood and clearly intended that Mrs. Heber's interest thereafter would be that of a life estate in one-half of the Fullerton Properties. The Court further stated thereafter that this was true regardless of the precise words used because (citing the Estate of Franco 190 Cal. 28, 210 P. 417), if there is an unqualified disposition of the rents, issues and profits of a fund or property, real or personal, this is a disposition of the fund or property itself. Further, the Court cited the further provisions of Mrs. Heber's interest in that the Agreement of August 10, 1944, provided that the cash income would be maximized by the sale of unproductive income parcels, applying the proceeds to reducing the encumbrances on the remaining parcels so as to thereby increase the cash flow income from the income producing parcels for distribution in part to Mrs. Heber; no further encumbrances could be incurred without Mrs. Heber's approval; and that in the event of illness, etc., where the income was not sufficient, the property values could be invaded (by way of Sale) for the benefit of either party.

In effect, the holding of the California court was that in construing the agreement of August 10, 1944, Mrs. Heber received an interest in the property itself, namely a life estate. This type of interest is clearly recognized under California law as an interest in real property under Civil Code Section 761.

~~Certainly~~ such a determination of property interests by

a state court having jurisdiction over the property and parties, and where each party has had adequate and full opportunity to be heard on the precise issue to be determined. Mrs. Heber's attempts to now relitigate these property interests should not now be considered by this court. See Commissioner v. Summen, 333 U.S. 591.

C. The Decision of the California Court Regarding Mrs. Heber's Interest in the Fullerton Properties as Being a Life Estate Must be Followed by the Tax Court

Although Judge Fay in his Tax Court opinion did not expressly follow or adopt conclusively the California court decision in Steeve v. Yaeger, supra, it is submitted that this was conclusive as to the determination that Mrs. Heber did in fact possess a life estate interest in the Fullerton properties.

The conclusiveness of state court adjudications regarding property rights and interests in a long established principle as set forth in Freuler v. Helvering, 291 U.S. 35 (1934) and Blair v. Commissioner, 300 U.S. 5 (1937). Each of these cases set forth that if taxability flowed from ownership of property interests, determination of those property rights and interests by a state court must be followed in any subsequent tax litigation. Of course, pursuant to the dicta in these cases and subsequent cases, such as Gallagher v. Smith, 223 F.2d 28 (3rd Cir. 1955), if it can be shown that the state court proceeding was "collusive" or not an adversary contest, the Commissioner of Internal Revenue should not necessarily be

bound by it.

The Respondent here, Miss Yaeger, submits that no facts were submitted or even suggested that the purpose of either the Agreement of August 10, 1944, or the resulting litigation between Heber and Yaeger, had any tax motives. Certainly the issue of the property interests thereby determined were not prompted by either party's intent to shift a tax burden to the detriment of the Commissioner. In fact, the Commission has taken the position from the first instance of this case that the Government is essentially neutral as to the identity of who is taxable for the income from the Fullerton Properties. Also, it is certainly a fair statement that the litigation in Steeve v. Yaeger, supra, was certainly not "collusive" or lacking in adversary qualities.

For this reason, the Respondent further submits that the Tax Court was clearly bound to recognize the California court's determination that Mrs. Heber owned a life estate in the Fullerton Properties under the principle of the cases cited.

- D. The Tax Incidence from Rental Income Must be Borne by the Person Owning the Interest in the Property and who is Thereby Entitled to Receive Those Rents

The Tax Court having found that Mrs. Heber was the owner of an undivided one-half life estate in the Fullerton Properties, concluded that the taxability of the rentals received from those properties was taxable one-half to Mrs. Heber and one-half to Miss Yaeger. As authority for such a

result, the Tax Court cited Rev. Rul. 56-221, C.B. 1956-1 58 (Tr. Vol. I., PP. 70) where the Commissioner ruled that where a mother and two children, who each held an undivided one-third interest in the fee simple interest of a property, rearranged their interests by deed so that the mother owned a life estate in the property, the mother was taxable on all of the gross rents from the property during the period of her life estate.

As set forth in the Government's brief to this court (Gov. Br. 21 and 22), there is no question that income from rents is included in gross income of a taxpayer under Section 61(a) of the Internal Revenue Code. Further, the Government sets forth ample authority that co-tenancy interests in property are taxable for their respective proportions of the income derived from the property. The character of the income is determined by the property interest involved and the income is then taxed to the owner of the property interest.

As the Respondent has urged above, the Tax Court was bound to recognize the life estate interest of Mrs. Hebe as determined in Steeve v. Yaeger, supra. The Respondent urges further that the Tax Court correctly applied the rule of law that the incidence of tax on the Fullerton Property income should follow ownership of the property interest. To shift the tax incidence to another party, i.e., Yaeger here, requires that the Tax Court accept the state court's determination of property interests but refuse to accept the general

tax consequences dictated from those property interests.

Refusing the state court's determination can be justified if the State law determinations lead to results contrary to express or implied intent of the Internal Revenue Code. Naturally, the federal income tax law must be consistently applied to all citizens and this determination must be made by the Federal Court--not dictated to it by the State Courts. Regardless of the inconsistencies thereby created in the federal law application to citizens of the various states, for example, in Lyeth v. Hoey, 305 U.S. 188 (1938), the court refused to apply a federal tax statute strictly within the terms of the state court's language and characterization describing an heir's acquisition of property as "by inheritance." Other interpretations were possible and the Federal Court sought to resolve the fact situation and interpret the law of taxation "so as to give a uniform application to a nationwide scheme of taxation".

The Respondent submits that no such justification appears in this case. The life estate of Mrs. Heber as found by the California court in Steeve v. Yaeger, supra, did not depend on any special characteristics of the California law. Certainly the general application Section 61 of the Internal Revenue Code and related authority would be universal to life estate interests created under the laws of any state.

Another justification for refusing to follow tax results flowing from state court determinations of property rights is where to do so violates a basic principle of tax law that

substance should control over form. Probably most of the contentions set forth by Mrs. Heber in her brief here on appeal can be grouped in this category. The basis of each contention is essentially that although Mrs. Heber may have received a life estate in form, it is not a life estate in substance but something else.

Mrs. Heber, of course, makes such contentions to support her interpretation of the agreement of August 10, 1944, and the resulting position that she sold a capital asset in 1944. In such she is now merely receiving payment for said sale and does not in fact own an interest in the Fullerton Property. To-wit: Mrs. Heber's arguments that the receipts of money by her are analogous to an involuntary conversion (H. Br. p. 15); to an annuity (H. Br., p. 16); to a trust (H. Br. p. 20).

Although not specifically raised here by Mrs. Heber, the above contentions are similar to the argument that Mrs. Heber was merely entitled to receive payment from Miss Yeager out of the net rental received from the Fullerton Property. As the Tax Court indicated itself (tr. Vol. I, PP. 21, footnote 6), such a theory would negate the tax consequences of the life estate to Mrs. Heber, but the facts as determined by both the Tax Court and the California Court in Steeves v. Yaeger, supra, would not support such a result.

A similar question is posed where a party seeks to shift the tax burden of rental income to another party. In Bigelow v. Bowers, 22 F 2d 450 (D.C.N.Y., 1927), the court held that

grantor of an interest in the "net rentals" of property remained taxable on the income because the actual control of the properties was completely retained by the grantor. Although the court acknowledged the form used evidenced a life estate, it was convinced that in substance the ownership control, responsibilities and risks were still entirely with the grantor and that the grantor had in fact assigned his income only rather than transfer the property interest from which the income derived.

The Respondent here urges that Mrs. Heber did in fact receive and still holds an undivided one-half life estate in the Fullerton Properties which was not only created in the proper form but is also valid in substance. The Agreement of August 10, 1944, created separate but equal life estates to one-half of the Fullerton Properties. Each life tenant had the right to receive the income after the cash expenses paid directly to earn this income. Each was liable for the debts incurred and neither could encumber the property without the permission of the other. Each had the right to evict tenants for non-payment of rent, collect the rents and in all other ways deal with the property as a co-tenant. The Agreement did not give the power or the right to either party to exclusively manage or control the properties. Miss Yaeger did attempt to assert such a power but Mrs. Heber promptly curtailed this effectively in her state court action. The Court in Steeve v. Yaeger, supra, and the Tax Court below

both have determined that each life tenant was entitled to their respective share of depreciation and that it could be deducted before determining the rental income payable each life tenant. The risks of earning and ultimately receiving this rental income were to be borne equally by parties during the natural life of Mrs. Heber.

For these reasons, the Respondent, Miss Yaeger, submits that one-half of the income from the Fullerton Properties is taxable to Mrs. Heber and cannot under any theory be taxed to Miss Yaeger, who did not own, control or otherwise have any right to that income or the property interest from which it generated. The result is exactly the same whether Mrs. Heber sold her partnership interest in 1944, exchanged it for a "different bundle of rights" as contended by Mrs. Heber (H. Br., p. 11), or merely received her property interest as a distribution of the partnership assets.

II

THE TAX COURT IN ITS OPINION AND DECISION SHOULD HAVE ALLOWED THE DEDUCTIONS TO MISS YAEGER IN 1955 AND 1957 IN THE AMOUNTS OF \$9,086.39 and \$3,766.32 RESPECTIVELY, BECAUSE THE DEDUCTIBILITY OF THESE AMOUNTS WAS IN LAW DETERMINED BY THE TAX COURT'S DETERMINATION THAT MRS. HEBER OWNED A ONE-HALF LIFE ESTATE INTEREST IN THE FULLERTON PROPERTIES AND THE INCOME EARNED FROM THOSE PROPERTIES.

The Tax Court in its Opinion (Tr. Vol. I, PP.74) stated that since Yaeger had not argued on brief regarding the Government's disallowance of deductions in the amount of \$9,086.39 in 1955 and \$3,766.32 in 1957, the court assumed Miss Yaeger had abandoned the deductions.

This was incorrect in that these deductions were not separate issues to be decided but in fact directly related to and part of the basic issue of whether Heber owned a life estate in one-half of the Fullerton Properties.

The deductions were disallowed in the deficiency notices sent to Miss Yaeger and copies of which were set forth and included in Miss Yaeger's Petition to the Tax Court (Tr. Vol. I, PP. 1-14). Specifically, the 1955 deduction in the amount of \$9,086.39 was disallowed by the Commissioner as being a capital expenditure although he had previously allowed it in a prior examination (Tr. Vol. I, PP.10). The previous allowance referred to by the Commissioner was a refund claim filed by Miss Yaeger and identified in the Computation of Tax under Rule 50, (Tr. Vol. I, PP.83 and 85).

The 1957 deduction in the amount of \$3,766.32 was also disallowed by the Commissioner as being a capital expenditure

(Tr. Vol. I, PP.13). This deduction was not included in the Computation under Rule 50 because Miss Yaeger had claimed it on her 1957 tax return directly as a deduction and received the benefit of it without the necessity of filing a refund claim as had been done in the case of the 1955 deduction of the same nature.

To project the true nature of these deductions requires an examination of the Commissioner's own actions with respect to them. Pursuant to the California Court decision in St. v. Yaeger, supra, Miss Yaeger paid the previously withheld income to Mrs. Heber. These payments were made in 1955 and 1957 as stipulated by the parties hereto (Ex. 14-N, Tr. Vol. I, PP.48) and as found by the Tax Court in its Findings of Fact (Tr. Vol. I, PP.59-60). As there stated the payments to Mrs. Heber were \$27,093.45 of which \$9,086.39 was paid in 1955 and the balance of \$18,007.06 was paid in 1957.

Naturally, Miss Yaeger was not entitled to deduct the payments to Mrs. Heber per se but if she had previously reported all or a part of them under a claim of right, and thereby paid a tax on said income, she would be entitled to a deduction. Judge Fay in his Opinion for the Tax Court took notice of this possible result in distinguishing the theory that Yaeger would be taxable on one-half of the earnings as trustee for Heber (Tr. Vol. I, PP. 73, footnote 9).

After determining the amounts of Heber income actually included in her own prior years' income, Miss Yaeger intended a refund claim for the tax year of 1955 in December of 1957.

based on a recomputation of her 1955 tax liability. Said claim set forth the results of Steeve v. Yaeger, supra, and included a complete analysis of the income previously reported for the tax years 1944 through 1952 by Miss Yaeger including that portion of Heber income reported under claim of right, and the excess thereby determined over that for which she was taxable consistent with the California Court decision. The excess was determined to be \$12,852.71 which was examined and allowed in full by the Commissioner. Under Section 1341 of the Internal Revenue Code, the deduction for the payment of this previously reported income to another person can be claimed only in the year of payment by a cash basis taxpayer i.e. Miss Yaeger. Accordingly the Commissioner allowed the deduction of \$9,086.39 (the extent of payments made that year in Miss Yaeger's 1955 refund claim resulting in a refund payment to her in the amount of \$4,948.52 on September 17, 1959.

While this refund claim was in process, Miss Yaeger deducted the balance of the deduction on her 1957 tax return to-wit:

Excess income under Section 1341	\$12,852
Less claimed deduction on 1955 return by way of refund claim	<u>9,086</u>
Balance to be deducted	<u>\$ 3,766</u>

Subsequent to these events, the Commissioner had begun his review of Mrs. Heber's tax returns and found she was not reporting the income from the Fullerton Properties consistent

with the decision in Steeve v. Yaeger, supra. This Audit of Mrs. Heber led to a re-examination of Miss Yaeger's return and in toto, the case now before this court.

As a result of his audit examinations, the Commissioner asserted the inconsistent positions whereby he contended that the co-tenants of the Fullerton Properties, Mrs. Heber and Miss Yaeger, were both charged with the one-half of the income determined by the Court in Steeve v. Yaeger, supra belonging to Mrs. Heber. Thus in the deficiency notice to Miss Yaeger for 1955 (Tr. Vol. I, PP.10) and 1957 (Tr. Vol. I, PP.13) the Commissioner asserted that she was taxable on all of the income from the Fullerton Properties including Mrs. Heber's share. The theory of course was that Miss Yaeger had purchased Mrs. Heber's interest in the property in 1944 and therefore was the sole owner of the entire properties.

To be consistent in his deficiency notice, the Commissioner then disallowed the previously allowed deduction in 1955 and the deduction taken by Miss Yaeger in 1957 regarding payments to Mrs. Heber as a result of Steeve v. Yaeger, supra. Obviously, Miss Yaeger was merely paying for the interest. The Commissioner was asserting that she owned and therefore she was making a capital expenditure.

Thus, both deductions were denied as a direct and axiomatic result of the issue raised that Miss Yaeger in fact owned the entire Fullerton Properties and Mrs. Heber's

not own a life estate in one-half of the income of these properties. They were not separate issues because the Commissioner had already passed on the validity and propriety of the deductions when he granted Miss Yaeger's refund claim in 1959. He raised them later only because these deductions he had approved became inconsistent with his deficiency notice regarding the ownership of the one-half of the income which the Tax Court has now found is taxable to Mrs. Heber.

For this reason, the Respondent urges now that the decision of the Tax Court be modified to provide that the deductions denied Miss Yaeger in 1955 and 1957 be allowed and the computation under Rule 50 be also accordingly modified. Then the rules of law and the holding of the Tax Court will be consistently and correctly applied to all of the facts and issues in this case.

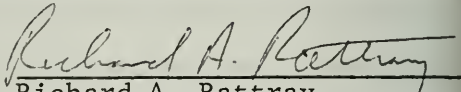
The Respondent urges this result on appeal here without having previously filed a separate Petition for Review. The Respondent feels that the Commissioner's own Petition for Review has raised the ultimate issue as to who is taxable on the one-half of the income from the Fullerton Properties and as set out above, this issue encompasses and includes the deductions claimed by Miss Yaeger in 1955 and 1957. See Commissioner of Internal Revenue v. Kelly's Estate, 84 F. 2d 958 (C.A.7th, 1936).

CONCLUSION

On the Commissioner's appeal here the opinion of the Tax Court regarding the determination that Mrs. Heber own an undivided one-half life estate interest in the Fuller Properties and the income derived therefrom should be affirmed. However, the Tax Court's decision should be modified to allow Miss Yaeger the deductions in 1955 and 1957 denied to her in the Tax Court's Decision.

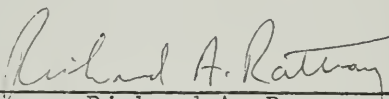
Dated: December 30, 1965.

Respectfully submitted


Richard A. Rattray
Counsel for Respondent Yaeger

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that in my opinion the foregoing brief is in full compliance with those rules.



Richard A. Rattray

